

The Loan Arranger



Winter 1999

Municipal Facilities Section - Environmental Assistance Division
Michigan Department of Environmental Quality **DEQ**

Policy for New Systems in the Drinking Water Revolving Fund

By Chip Heckathorn

On November 3, 1998, the U.S. Environmental Protection Agency published a policy decision in the Federal Register that will allow states to make loans from the Drinking Water Revolving Fund (DWRf) to construct systems to solve public health problems for residents currently served by individual wells. This policy expands the universe of eligible loan recipients by allowing loans to an entity that is not currently a public water system but will become a public water system upon project completion.

The establishment of the DWRf in the 1996 amendments to the Federal Safe Drinking Water Act created some uncertainty regarding eligible projects. Section 1452(a)(2) of the Act stated that financial assistance "may be used by a public water system only for expenditures...which...will facilitate compliance with national primary drinking water regulations..." This language led to an initial position that DWRf funds could only be awarded to an existing public water supplier/system. The recent policy decision now allows funds to be awarded to an entity that upon project completion will be a public water supplier/system.

When reviewing an application for assistance under this policy, the state must ensure that the applicant has given sufficient public notice to potentially affected parties and has considered alternative solutions to addressing the problem; requirements that would normally be met during a good project planning process. In addition, a project can only qualify for assistance if the following conditions are met:

a) *Upon completion of the project, the entity responsible for the loan must meet the definition of a Federal community public water system;*

b) *The project must be on the State's fundable list and must address an actual public health problem with serious risks;*

c) *The project must be limited in scope to the specific geographic area affected by contamination;*

d) *The project can only be sized to accommodate a reasonable amount of growth expected over the life of the facility--growth cannot be a substantial portion of the project;*

e) *The project must meet the same technical, financial and managerial capacity requirements that the Safe Drinking Water Act requires of all DWRf assistance recipients; and*

f) *The project is a cost-effective solution to solving the public health problem.*

The Municipal Facilities Section of the Environmental Assistance Division, and the Drinking Water and Radiological Protection Division are currently preparing procedures to implement this new policy. Questions about the policy can be directed to Mr. Chip Heckathorn at 517-373-4725 or Mr. Richard Benzie at 517-335-8303.

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Michigan's Source Water Assessment Program By Bradley Brogren, DWRPD

The 1996 amendments to the federal Safe Drinking Water Act require states to submit source water assessment programs (SWAP) for U.S. EPA approval by February 6, 1999. The intent of SWAP is to identify the sources that supply public tap water; inventory contaminants, and assess water supply susceptibility to contamination; and inform the public of the results. Michigan has almost 12,000 community and noncommunity public water supplies, with an estimated 18,000 sources that must be assessed. With the allowable 18 month extension, the assessments themselves must be completed by May 2003.

In 1997, the state of Michigan reserved the maximum federal financing available, a one time 10 percent set-aside for SWAP from the initial federal capitalization of the Drinking Water Revolving Fund to fulfill the program requirements.

The Drinking Water and Radiological Protection Division (DWRPD) initiated SWAP in Fiscal Year 1998 by completing noncommunity assessment contracts with Michigan State University and local health departments, convening SWAP advisory committee meetings, and conducting numerous training sessions. In addition, the DWRPD entered into a Joint Funding Agreement with the U.S. Geological Survey, held SWAP public meetings and presentations, initiated assessment discussions with the city of Detroit, and began drafting the SWAP document.

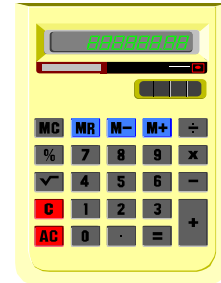
Assessments of noncommunity public water supplies are currently underway by local health departments. Well-head protection will be the intended mechanism through which assessments will be completed on community groundwater supplies. Source water protection set-asides of \$1,000,000 per year from the Drinking Water Revolving Fund will provide matching grants to communities beginning in 1999 as incentives to pursue well-head protection. Community groundwater supplies not instituting a wellhead protection program will be assessed by DWRPD staff.

Surface water is a drinking water source for approximately 50 percent of Michigan's population. The state's 70 surface water intakes will be assessed by the DWRPD with assistance from the U.S. Geological Survey. Ten of these intakes are on inland rivers which warrant assessments on a watershed basis. Our Great Lakes and connecting river intakes will be assessed on a site specific basis following the Great Lakes Protocol being adopted by the Great Lakes states. DWRPD staff are currently working with the Detroit Water and Sewerage Department and the U.S. Geological Survey to

develop a flow model of the St. Clair River, Lake St. Clair, and the Detroit River system. Fourteen public water supply intakes are on this system, including two for the city of Detroit. Pilot assessments on selected intakes will be initiated in 1999.

For further information concerning the Michigan SWAP, you may contact Bradley B. Brogren, P.E. at 517-335-8311. The SWAP document is available on the DWRPD internet site at <http://www.deq.state.mi.us/dwr>.

Capitalized Interest



Capitalized interest or funded interest is defined as a portion of the proceeds of a bond issue that is set aside, upon issuance of the bonds, to pay interest on the bonds for a specified period of time.

Capitalized interest is traditionally used in sewer and water system financing to fund interest payments on bonded debt until utility system revenues become available to service the bond payments. This would occur, for instance, when a brand new water system is constructed and the customers from whom revenue is to be collected are not hooked up for a year or two after the bonds are issued. Capitalized interest is not traditionally provided for in a project's financing budget where the utility system is already operating and producing revenue flows.

The clean water State Revolving Fund (SRF) and Drinking Water Revolving Fund (DWRF) programs permit borrowers to include capitalized interest in their loan requests. Capitalized interest can be permitted from the borrowing date of a loan up to a point not more than six months prior to the first principal payment, but not more than three years. Original SRF program guidelines permitted capitalized interest to be included for any community that requested it, with no determination made for necessity.

Certainly one major objective of both the SRF and DWRF programs is to provide as much assistance and to fund as many projects as possible with available, albeit limited resources. Experience with the SRF program has demonstrated that many communities choose to include capitalized interest in their loan requests without regard to necessity and revenue flow

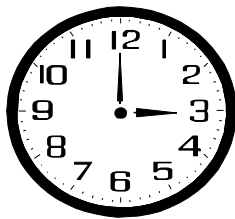
considerations. We have learned that the rationale is related to avoidance of rate-payer impact in some cases, and application of economic principles (cost of money) in others.

These observations led us to conclude that most program participants did not really “need” to capitalize interest, but did so merely because it was permitted. The consequence of this reality is that program funds were being allocated to a use that was permitted, but unnecessary, therefore diminishing the loan pool available to assist other communities.

Clearly, a distinction in need for capitalized interest can be made between communities that already have revenue producing utility systems in operation versus brand new construction programs where no revenue occurs until operation begins. In addition, even when communities determine to use an alternative revenue support system for their bond payments, such as property tax levies or special assessments, in most instances the utility system revenues for existing systems can be used to service the initial bond interest payments.

Commencing in Fiscal Year 1999, capitalized interest will not be an eligible project expense unless the borrower is constructing a new water or sewer system and no current utility system exists to produce revenue for bond payments during the construction period.

Y2K Clock is Still Ticking



While it has been in the news for many months, there are some who are not yet working toward becoming compliant with the computer date problem known as **Y2K**. The DEQ, and specifically the EAD and the DWRPD, have taken steps to ensure compliance for the SRF and the DWRP programs. However, the consulting engineers, bond counsels, and the local communities which the DEQ serves must also take steps to ensure that all computers and machinery with imbedded chips will function as the millennium changes less than a year from now.

Equipment failure in wastewater and water supply facilities cannot be used to excuse non-compliance with discharge permits or water supply requirements should

the equipment not be Y2K compliant. Steps must be taken **now** to ensure that environmental or public health disasters will not occur as the next New Year rings in.

Each entity must take responsibility to ensure that it is ready. You may wish to contact a consultant specializing in Y2K compliance, or search the web for the wealth of information that can help you analyze your situation.

Discount Rate for Fiscal Year '99

On October 30, 1998, the EPA published the discount rate for FY99. For project planning that begins on or after October 1, 1998, a discount rate of **6 7/8 percent** (6.875%) needs be used. This rate is 1/4 of a point below that used for planning that began in FY98. Remember, this is NOT a rate that should be used to estimate debt retirement needs (2 1/2%, the rate of our SRF and DWRP loans does that), but rather is to be used in cost effective analyses to “bring” future expenditures back into today’s dollars for total present worth or equivalent annual cost comparisons.



”A Financial Discussion”

By Marshall Labadie

The clean water State Revolving Fund (SRF) and the Drinking Water Revolving Fund (DWRP) provide low-interest financing to qualified applicants. This low-interest financing is used to make capital improvements to wastewater or drinking water related infrastructure to address an existing need and/or to maintain compliance with applicable laws and permits. In order to obtain this low-interest financing, applicants have to meet certain programmatic requirements set fourth in Michigan’s Natural Resources and Environmental Protection Act, Part 53 or 54, 1994 PA 451.

The topics of project planning, the State Environmental Review Process, milestone scheduling, and project scoring and ranking have been discussed in the past. The following will discuss the SRF and DWRP financial structure and the requirements this structure establishes for the applicant.

An SRF or DWRP low-interest loan offers many advantages over open market financing. These advantages include:

- * interest rates that are well below market levels
- * principal payments due after construction, not upon loan issuance
- * known rates of interest which protect against market fluctuations
- * interest payments during construction based on amounts drawn, not on total loan amount

The Municipal Facilities Section (MFS) and the Michigan Municipal Bond Authority (MMBA) jointly administer the financial review portion of the SRF and DWRP process. The MMBA examines financial information of the applicant that is submitted in Part 1 of the loan application. The MFS Project Manager will help the applicant compile this financial information and complete associated tasks required for loan closing and project approval. In so doing, they will negotiate a project milestone schedule that identifies the critical completion dates of the SRF or DWRP approval process.

The SRF and DWRP loans are structured similar to conventional open market municipal borrowing in that the applicant must prepare municipal bonds to facilitate its SRF or DWRP debt obligation. With few exceptions, such as installment purchase contracts, **all municipalities have to issue bonds to incur debt under Michigan law.** The applicant, however, need not close the sale of the bonds on the open market, but only prepare them for sale. The MMBA will assess the rating assigned by a rating agency such as Standard & Poors or Moody's Investor Services, along with the applicant's financial status. Upon a favorable evaluation of the bonds and other related financial information, the MMBA will purchase the bonds under the program's pre-set loan conditions after receipt of an Order of Approval from the DEQ.

The preparation of the municipal bonds creates several financial requirements for the applicant which must be completed prior to the project approval and loan closing. These requirements include:

- * obtaining an investment-grade credit rating, or engaging some other form of credit enhancement
- * obtaining a bond counsel opinion
- * issuing a bond resolution or ordinance

- * ensuring that any necessary referendums have been held
- * acquiring MFS approval of the User Charge System
- * receiving a positive review from the MMBA's financial advisor
- * signing other agreements, covenants, and contracts related to the bond sale

The loan prerequisites listed above are utilized to determine an applicant's ability to repay the debt obligation, as well as its ability to operate and manage the constructed facility. (The DWRP contains provisions that allow private water suppliers to receive financing. Certain restrictions and different loan conditions may apply, so contact the MFS for more information.)

What exactly do these loan prerequisites mean for the applicant? Most applicants should retain the services of a financial advisor and bond counsel for assistance early in the planning stage. Soliciting these professional services early does not cost the applicant any additional money over waiting until shortly before application due dates. Early recognition of all the financial requirements eases the loan application process and avoids any unwanted project delays and costs. It can also help by identifying whether or not the act under which the borrowing occurs requires a public referendum which must be held prior to the Order of Approval. This planning foresight can provide the applicant with additional time should any unanticipated delays or tasks surface while attempting to secure SRF or DWRP financing.

Knowledge of the program's financial structure and associated financial tasks is a key element for an applicant's success in securing SRF or DWRP assistance. While the description above is brief, it is our hope that this article provides an overview of applicant requirements and the advantages our program offers over open-market borrowing. Contacting the MFS early is truly the best way to obtain a complete and detailed understanding of the program's financial requirements, the application process, and other tasks needed for project approval and timely loan closing. The MFS telephone number is 517-373-2161.

On the Move

After four years with the Municipal Facilities Section (MFS), **Mike Young** has accepted a new position in the Pollution Prevention Section -- still within the DEQ Environmental Assistance Division. Most recently, Mike was providing project management services for SRF and DWRP projects in the East Unit of the MFS, and we will truly miss his hard work and dedication to assisting communities with their revolving fund projects. We wish Mike continued success with his new responsibilities.

Divine Calling



Ed Moyer, Chief of The Technical Support Unit, will leave State Service in early March. Ed was intimately involved in drafting the state legislation for the State Revolving Fund and most recently, the Drinking Water Revolving Fund.

In addition to Ed's assistance in financing, and being our in-house expert in that area, he was responsible for the day-to-day oversight on User Charge System reviews; all our computer needs; and probably of most importance to municipalities, the timely processing of all disbursement requests for our loans.

Ed has also provided assistance to the Association of State and Interstate Water Pollution Control Administrators. Ed was responsible for development of environmental education materials in celebration of the 1992 Year of Clean Water, celebrating 20 years of the Clean Water Act. This material was distributed nationally and received high accolades. Ed also administered a grant from the EPA to develop a student information kit that celebrated Earth Day and was made available to all schools in the state for classroom use. In addition, Ed represented the Department at the Council of Infrastructure Financing meetings and seminars.

Ed has accepted the call to be Pastor of Administration for his church, the OakBrook Community Church of Lansing. Ed will leave State Service just shy of his 20th anniversary with the Department of Environmental Quality and the Department of Natural Resources. While Ed will be missed by all who worked with him, we can share with him the joy and purpose of his new calling. He now goes from the stewardship of the environment to the stewardship of faith. Good luck Ed, and God speed.

DWRF Outreach

By Ed Moyer

As part of the continuing efforts to disseminate information about the SRF and DWRF programs, DEQ and Michigan Municipal Bond Authority (MMBA) officials participated in two panels during the annual meeting of the Michigan Townships Association held recently in Detroit. In all, the panel spoke to over 100 township officials and provided an opportunity for specific questions.

Ed Moyer, Chief of the Technical Support Unit, began by presenting an overview of the steps necessary to obtain loan assistance from the DWRF. Mr. Moyer discussed the qualifications for participating water suppliers, highlighting eligible and ineligible project components, the submittal of project plans, and the criteria for ranking on the Project Priority List.

Christopher Dembowski of the firm Miller, Canfield, Paddock and Stone, serves as MMBA's bond counsel and addressed the attendees regarding the role of the bond counsel in financing DWRF or SRF loans. Mr. Dembowski stressed the importance of involving the bond counsel early in the decision-making process, rather than waiting until the end.

Paul Stauder of Stauder, Barch and Associates, then shared information on how the townships could make the assessment of cost in determining whether or not a project would be affordable. He cautioned that the townships must demonstrate that they either have investment grade bond ratings or will use other credit enhancements to qualify for DWRF assistance. Sound financial analysis is extremely important, based on the examination of the operation and maintenance costs, existing or planned debt, and the economic conditions directly impacting the project area.

The DEQ and the MMBA view outreach opportunities as a valuable tool in promoting ways we can help Michigan communities address their infrastructure financing needs.



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